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In the

Supreme Court of the United States

October Term, 1984

ANTHONY MATERIA,

Petitioner,

-v-

THE SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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APPEALS FOR THE SECOND CIRCUIT

Petitioner Anthony Materia prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in this case.

QUESTIONS PRESENTED

1. Whether a finding of liability for securities fraud under Section 10(b) of the Securities Exchange Act of 1934 may be based solely on the use of non-public "outside" information, without any allegation that the defendant owed any duty of disclosure to any person who purchased or sold securities?

2. Is an employee's breach of his duty of loyalty to his employer, a fraud in connection with the purchase or sale of securities, when the employee uses the fruits of his breach to purchase securities of another company which has no relationship with his employer or his employer's principal?

3. Is Rule 14e-3 permissible exercise of the Securities and Exchange Commission's rulemaking authority, when the Rule imposes a duty to disclose when said duty is contrary

to the decisions of this Court without any evidence of Congressional intent to impose such a duty?

4. May the express language of a statute provide different theories of liability, to different persons or entities, while other persons or entities cannot rely upon the same theory?

TABLE OF CONTENTS

	PAGE
QUESTIONS PRESENTED	(ii)
OPINION BELOW	1
JURISDICTION	1
STATUTES AND REGULATIONS INVOLVED	1
STATEMENT OF THE CASE	5
REASONS FOR GRANTING THE PETITION	
I. THE COURT BELOW HAS IMPROPERLY RESOLVED THE ISSUE LEFT OPEN BY THIS COURT IN CHIARELLA V. UNITED STATES BY FEDERALIZING BREACHES OF DUTY WHICH ARE WHOLLY WITHIN THE PROVINCE OF STATE LAW	11
II. DETERMINATION OF THE VALIDITY OF THE MISAPPROPRIATION THEORY IS VITAL TO THE SECURITIES INDUSTRY AND TO THE STATUS OF THE FEDERAL SECURITIES LAWS	15
A. The Misappropriation Theory is an Impermissible Attempt at Creating an Equal Information Rule	21
III. THE INSTANT CASE PRESENTS THE FIRST OPPORTUNITY FOR THE COURT TO ADDRESS THE VALIDITY OF RULE 14e-3, AND SAID DETERMINATION IS IMPERATIVE TO THE STATUS OF THE FEDERAL SECURITIES LAWS	25

TABLE OF CASES (cont'd)

	PAGE
IV.. THE COURT BELOW HAS IMPROPERLY CREATED DIFFERING STANDARDS OF LIABILITY UNDER RULE 10b-5, VARYING ONLY WITH THE IDENTITY OF THE PLAINTIFF	31
Appendix	
OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT	1a
JUDGMENT OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT	15a

TABLE OF CASES

Aaron v. SEC, 446 U.S.680 (1980)	7, 32
Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2nd Cir), cert. denied, 343 U.S. 956 (1952)	19
Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975)	
Chiarella v. United States, 445 U.S. 222 (1980)	6, 11 13, 14, 20, 24

TABLE OF CASES (cont'd) PAGE

Dirks v. SEC, _____, U.S. _____, 103 S.Ct. 3255 (1983) 6, 12, 14, 22, 23, 24

Ernst & Ernst v. Hochfelder 425 U.S. 185 (1976) 27

Moss v. Morgan Stanley, Inc., 719 F.2d (2nd Cir. 1983) 7, 33

Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977) 14, 20, 27

Superintendant of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1972) 19, 20

U.S. v. Newman, 664 F.2d 12 (2nd Cir. 1981), cert. denied, ____, U.S. _____, 104 S.Ct. 193 (1983) 6, 32

STATUTES AND REGULATIONS

Securities Exchange Act of 1934, 15 U.S.C. §78(a), et seq.:

Section 10(b), 15 U.S.C. §78j (b)..... passim
Section 14(e), 15 U.S.C. §78n (d)..... passim

OTHER AUTHORITIES — PAGE

Senate Comm. on Banking and Currency, Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids, S. Rep. No. 550, 90th Cong., 2nd Sess. (1967) 28

Bills Providing for Full Disclosure of Corporate Equity Ownership Under the Securities Exchange Act of 1934: Hearings on H.R. 14475 and S.510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency, 90th Cong. 1st Sess. (1967) 29

House Comm. on Interstate and Foreign Commerce, H.R. Rep. No. 1711, 90th Cong. 2nd Sess. (1968) 28

A Bill to Extend the Coverage of Sections 13(d), 14(d) and 14(e) of the Securities Exchange Act of 1934 in Order to Provide Additional Protection for Investors: Hearings on S. 3431 Before the Subcomm. On Securities of the Senate Comm. on Banking and Currency, 91st Cong. 2nd Sess. (1970) 30

An Act to Amend Sections 13(d), 13(e), 14(d) and 14(e) of the Securities Exchange Act of 1934 In Order to Provide Additional

OTHER AUTHORITIES (cont'd) PAGE

Consumer Protection for Investors: Hearings on S-3431 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, 91st Cong. 2nd Sess. (1970) 30

Memorandum of the Securities and Exchange Commission in Support of the Insider Trading Sanctions Act of 1982, reprinted in H.R. Rep. No. 98-355, Report of the Committee on Energy and Commerce, accompanying H.R. 559, 98th Cong. 1st Sess. 32 16, 17

OPINIONS BELOW

The United States Court of Appeals for the Second Circuit affirmed the final order of injunction and disgorgement entered by the Honorable Charles L. Brieant, of the United States District Court for the Southern District of New York. The Court of Appeals decision, dated October 1, 1984, which is unreported, is set forth in the Appendix ("App.") at 1a - 14a.

JURISDICTION

Jurisdiction to review the Court of Appeal's October 1, 1984 judgment, is vested in this Court by 28 U.S.C. §1254(1).

STATUTORY PROVISIONS AND REGULATIONS INVOLVED

Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. §78j(b), provides:

§78j. Manipulative and deceptive devices

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange -...
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 of the Securities Exchange Commission ("S.E.C."), 17 C.F.R. §240.10b-5, provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange.

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Section 14(e) of the Exchange Act, 15 U.S.C. 78n(e), provides:

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statement made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any

> solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The Commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative.

Rule 14e-3, 17 C.F.R. 240.14e-3, provides, in pertinent part:

> (a) If any person has taken a substantial step or steps to commence, or has commenced, a tender offer (the "offering person"), it shall constitute a fraudulent, deceptive or manipulative act or practice within the meaning of section 14(e) of the Act for any other person who is in possession of material information relating to such tender offer which information he knows or has reason to know has been acquired directly or indirectly from (1) the offering person, (2) the issuer of the securities sought or to be sought by such tender offer, or (3) any officer, director, partner or employee or any other person acting on behalf of the offering person or

> such issuer, to purchase or sell or cause to be purchased or sold any of such securities or any securities convertible into or exchangeable for any such securities or any option or right to obtain or dispose of any of the foregoing securities, unless within a reasonable time prior to any purchase or sale such information and its source are publicly disclosed by press release or otherwise.

STATEMENT OF THE CASE

The decision below broke new ground in the area of securities law. It held for the first time that, in a civil action, an individual may be held liable for the unauthorized use of "outside" information, even in the absence of any duty owing to any party to a securities transaction or to the issuer of the securities.

The decision below also establishes a dual interpretation of Rule 10b-5, and creates

differing liabilities under Section 10(b) Rule 10b-5, depending upon the identity of the plaintiff. The decision below holds that there can be liability for the use of "outside" information when the United States government is plaintiff, whereas prior decisions of the same court have held that no liability attaches where a private individual seeks relief upon the same theory of liability and pursuant to the same statute and rule.*

*The instant case, like Chiarella v. United States, 445 U.S. 222 (1980), and Dirks v. S.E.C., ____ U.S.____ 103 S.Ct. 3255 (1983) involves the attempt by a regulatory agency to expand its jurisdiction beyond the scope as defined by this Court and Congress. The decision below expands the scope of liability under Section 10(b) of the 1934 Act and Rule 10b-5, beyond the commonly understood bounds of "insider trading", radically redefines the term "insider", and abrogates all notions of duty to a specific individual or group of individuals. This decision, together with the same court's decision in United States, Newman, 664 F.2d 12 (2nd Cir. 1981), cert denied,_____ U.S._____, 104 S.Ct. 193 (1983),

Lastly, the instant matter presents the Court with its first opportunity to review Rule 14e-3, a rule which creates liability without regard to any element of fraud, or wrongful conduct, and punishes the mere possession and use of non-public information.

Petitioner Anthony Materia ("Materia"), was employed as a copyholder by Bowne of New York City, Inc. ("Bowne") since 1974. Bowne is a financial printing company which, among other services, prints documents of a financial nature for a variety of clients, including annual reports, proxy statements, registration statements, prospectuses, tender offers and Forms 10K.

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*(cont'd)
and Moss v. Morgan Stanley, 719 F.2d 5 (2nd Cir. 1983), establishes a dicotomy in the securities laws, providing for different standards of liability, based upon whether or not the government is the plaintiff. This result is contrary to the prior teachings of this Court. See, Aaron v. S.E.C., 446 U.S. 680 (1980).

The first amended complaint alleged that Materia, while employed by Bowne, acquired material, non-public information regarding proposed tender offers, purchased the securities of the target companies, and further, conveyed the information to his wife, Concetta Materia.

The first amended complaint did not assert that Bowne, or any of its clients (the "victims" of the fraud) suffered any harm, nor did the complaint allege that any participant in any securities transaction was misled, deceived or defrauded, or suffered any loss.

United States District Judge Charles L. Brieant, after a bench trial, found that the tender offerors had an expectation of confi-

dentiality with respect to the information contained in the drafts, which Materia had "likely" access to, that the offer to purchase would be kept confidential, and that no Bowne employee would use the information for personal gain.

The court also found that Materia owed a fiduciary duty to Bowne and its clients, and that Materia's use of the aforesaid information, which enabled him, through outside means, to deduce the identity of the target company, and his subsequent purchase of the target companies' securities, constituted a breach of his fiduciary duty to Bowne.

The Court therefore concluded that Materia violated Sections 10(b) and 14(e) of the Securities Exchange Act and Rules 10b-5 and 14e-3 promulgated thereunder.

District Judge Brieant entered a final order of permanent injunction against Materia,

and ordered Materia to disgorge his profits from the four purchases and sales, in the sum of $99,862.50.

On appeal to the Court of Appeals for the Second Circuit, the decision of the District Court was affirmed and the court held "one who misappropriates nonpublic information to his own advantage violates Section 10(b) and Rule 10b-5". [App. 12a].

The Court of Appeals summarily rejected Materia's arguments that the fraud he is alleged to have perpetrated was not "in connection with the purchase or sale of a security" and although the Court explicitly recognized the limitations imposed by the "in connection with" requirement, the Court brushed aside such requirement and stated that because the information that Materia misappropriated had no value whatsoever,

except "in connection with" his subsequent purchase of securities, the requirement was met and Materia's argument was "spurious". [App. 13a]. The court also affirmed the decision as it pertains to Rule 14e-3.

REASONS FOR GRANTING THE WRIT

I. THE COURT BELOW HAS IMPROPERLY RESOLVED THE ISSUE LEFT OPEN BY THIS COURT IN CHIARELLA V. UNITED STATES BY FEDERALIZING BREACHES OF DUTY WHICH ARE WHOLLY WITHIN THE PROVINCE OF STATE LAW

The instant petition presents this Court with the opportunity to address the issue left open in Chiarella v. United States, 445 U.S. 222 (1980) (hereinafter "Chiarella"). In Chiarella, the Court held that Section 10(b) and Rule 10b-5 do not impose a "disclose or abstain" obligation upon an individual who obtains non-public information, who is not an insider, and who is not in a "special rela-

tionship" to the issuer or seller of the securities. The Court did not reach the question of whether an individual's breach of a common law duty to his employer, could provide the basis for liability, under Rule 10b-5.

The instant matter presents this very question in a factual setting which is virtually identical to Chiarella, and for the reasons cited herein, the Court should now resolve this question so as to adequately set down standards for insider liability.

This Court has repeatedly held that a duty to disclose arises from the relationship between the parties involved in the transaction and not merely because a party has possession of, or access to, information. Dirks vs. SEC, __ U.S. __ (1983), 103 S.Ct. 3255 (1983) (hereinafter referred to as "Dirks"); Chiarella, supra.

This Court has also held that a duty to disclose derives from the common law of misrepresentation, and in order for a failure to disclose to constitute a fraud, one party must have information that the other party is entitled to know because of a fiduciary or similar relation of trust and confidence between them. Chiarella, supra. However, the lower court's decision in this case has radically transformed the state of the law, and has now created a duty to disclose under Rule 10b-5 without a finding of an underlying relationship of trust and confidence which gives rise to such a duty.

This Court has consistently held that if a fiduicary relationship to the issuer, its shareholders, or the purchaser or seller of the securities is not established, there can be no duty to disclose, nor a duty to abstain or disclose, and therefore no Rule

10b-5 liabilty, for trading without disclosure. See, Chiarella, supra; see also, Dirks, supra; Santa Fe Industries, Inc. vs. Green, 430 U.S. 462 (1977).

To hold otherwise, and to adhere to the ruling of the court below, would create the most undesirable result of bringing "within the ambit of [Rule 10b-5] all breaches of fiduciary duty in connection with a securities transaction". (Sante Fe Industries, Inc. vs. Green, 430 U.S. at 472).

The instant case presents, at best, a breach of a common law duty of loyalty to an employer. There is no fraud, or manipulative or deceptive practice in connection with the purchase of a security, for Materia did not breach a duty to any person in a securities transaction.

It is respectfully submitted that the lower court erred in finding that Materia's breach of common law duty of loyalty to his employer is actionable under the Federal securities laws. The decision of the lower Court is contrary to the prior decisions of this Court, and this issue, which now federalizes every breach of duty under state law, should be addressed by this Court.

II. DETERMINATION OF THE VALIDITY OF THE MISAPPROPRIATION THEORY IS VITAL TO THE SECURITIES INDUSTRY AND TO THE STATUS OF THE FEDERAL SECURITIES LAWS

The decision below has radically altered the state of the Federal securities laws, and has expanded Rule 10b-5 beyond all boundaries established by Congress and this Court. This issue becomes particularly important in light of the recent enactment of the Insider Trading Sanctions Act of 1934, Pub.L. No. 98-376, ("the Insider Trading Act").

The Insider Trading Act tersely increased the penalties available for insider trading, but at the same time left the legal boundaries of the prescribed conduct as nebulous as before. Congress did not define the term "insider" and did not define the scope of the penalties under Rule 10b-5. Moreover, Congress was specifically asked by the Commission not to include such definition, and the Commission stated:

> Two insider cases are presently before the Supreme Court. Resolution of these cases [i.e. Dirks v. SEC and United States v. Newman] may change the contours of insider trading law... The flexibility which is gained by basing the imposition of the penalty on existing case law avoids the problems of freezing into law either a definition which is either too broad or too narrow to deal with newly emerging issues.

Memorandum of the Securities and Exchange Commission in Support of the Insider Trading Sanctions Act of 1982, reprinted in H.R. Rep. No. 98-355, Report of the Committee on Energy and Commerce accompanying H.R. 559, 98 Cong. First Session 32.

However, the Court did not grant the petition for certiorari in U.S. v. Newman, and in light of the decision in Dirks, the Commission has now changed its posture, and argues that Dirks must be narrowly construed and restricted to its facts.

The guidance of this Court is needed in order to develop a coherent doctrine of insider trading. This Court must once again resolve the issue of whether the statutory prohibition of insider trading in Rule 10b-5 is narrow, as defined by this Court Chiarella and Dirks, or whether it is to be applied

with a broad brush, to cure all of the perceived evils in our securities markets and to make the markets "fair", as defined by the Materia decision.

It is respectfully submitted that the misappropriation theory of Rule 10b-5, upon which the instant case was decided, is in error and is contrary to the decisions of this Court. The decision below expands the scope of Section 10(b) and Rule 10b-5 to an extent never contemplated by the Congress. It is submitted that the decision herein and its reliance upon the misappropriation theory, has radically transformed the Federal securities laws to be a catch-all remedy for all breaches of any duty where there is a subsequent purchase of securities. This theory, and its application to the instant case, is inconsistent with the decisions of

this Court limiting the relief available under Rule 10b-5.

It is beyond peradventure that in order to establish liability under Rule 10b-5, the manipulative or deceptive device must be in connection with the purchase of sale of the security. Superintendant of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1971). The fraud aspect of a 10b-5 violation must be of a sort that would cause reasonable investors to rely thereon, and in connection therewith, so relying, cause them to purchase or sell a corporation's securities. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2nd Cir.), cert denied, 343 U.S. 956 (1952).

Aside from the fact that the instant case lacks a manipulative or deceptive practice as defined by this Court, the purpose of the words "in connection with" are

to limit the coverage and scope of Rule 10b-5. A fraud which is not commited "in connection with" the purchase or sale of a security is simply not within the ambit Rule 10b-5.* This phrase requires a clear nexus between the alleged fraud and the purchase or sale of a security.

At the very least, the fraud must touch the sale of the security. Bankers Life, supra. Even in Bankers Life, the seminal case on the broad expanse of 10b-5 and the flexibility of its prohibitions, the defendants had committed a fraud upon the plaintiff, in connection with the sale of the plaintiff's securities.

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*There are many instances where Congress has chosen to leave the remedies to state law. See, e.g., Santa Fe Industries v. Green, 430 U.S. 462 (1977). Statutory schemes such as securities regulation must have general application, and consequently what may be perceived as unethical conduct is not necessarily illegal under a particular regulatory scheme. Chiarella, supra.

Clearly, Bankers Life did not set forth an unlimited "touch" test, and the prior decisions of this Court do not support a finding of liability herein, as there was no allegation that the fraud ever deceived any person with an interest or participation in the securities transactions. In fact, except for the Second Circuit in the instant case, no court has ever held Section 10(b) applicable where the "victim" of the fraud did not participate in the affected securities transaction.

In the instant case, there simply was no fraud which touched the purchase or sale of the securities at issue.

A. The Misappropriation Theory is an Impermissible Attempt at Creating an Equal Information Rule

The misappropriation theory employed by the Court below is in reality an "equal

information rule", requiring that all parties in a securities transaction to have equal information prior to trading to prevent an unfair inequality of information in the market.

In Dirks, supra, this Court specifically addressed this "equal information" theory and explicitly rejected it:

> "In effect, the SEC's theory of tippee liability in both cases [Chiarella and Dirks] appears rooted in the idea that the antifraud provisions require equal information among all traders. This conflicts with the principle set forth in Chiarella that only some persons, under some circumstances, will be barred from trading while in possession of material non-public information. Judge Wright [author of the Court of Appeals Decision in Dirks] correctly read our opinion in Chiarella as repudiating, any notion that all traders must enjoy equal information before trading: '[T]he information' theory in rejected."

103 S.Ct. at 3262 (footnotes omitted) (emphasis added). This Court went on to state, in a footnote, "[i]n Chiarella we noted that formulation of an absolute equal information rule 'should not be undertaken absent some explicit evidence of congressional intent' 445 U.S. at 233". 103 S.Ct. at 3262.

This Court has clearly rejected, and should continue to reject, a rule which requires equal information among all investors in the securities markets.

There can be no "duty in the air" in the federal securities laws, and yet the Commission consistently attempts to correct all of the perceived evils in the security industry by way of broad sweeping anti-fraud provisions requiring equal information among all traders.

This Court has clearly stated that there must be a breach of fiduciary duty

before a duty to disclose or abstain from trading arises. See Dirks, supra; Chiarella, supra.

The Commission's attempt, by use of the misappropriation theory, to do indirectly what the Court has forbade it to do directly is impermissible and violates the boundaries of the Federal securities laws. The disclose or abstain duty is extraordinary and can attach only when a party has legal obligations other than a mere duty to comply with the Federal securities laws. Dirks, ___ U.S.___, 103 S.Ct. at 3263. A duty to disclose cannot arise merely from one's possession of information. Dirks, ___ U.S. ___, 103 S.Ct. at 3263. There must be a specific duty between the parties, coupled with a fraud in connection with the securities transaction.

III. THE INSTANT CASE PRESENTS THE FIRST OPPORTUNITY FOR THE COURT TO ADDRESS THE VALIDITY OF RULE 14e-3, AND SAID DETERMINATION IS IMPERATIVE TO THE STATUS OF THE FEDERAL SECURITIES LAWS

After this Court's decision in Chiarella, the Commission devised Rule 14e-3, in an attempt to circumvent the Chiarella ruling and prohibit all persons other than the bidder, from trading on the basis of material non-public information regarding a planned tender offer. See, 17 C.F.R. §240.14e-3.

Rule 14e-3 imposes an abstain or disclose obligation under circumstances where no pre-existing fiduciary duty exists between the person possessing the information and the purchasers or sellers, and requires full disclosure by any person, in an effort to prevent an unfair inequality of information among investors.

Rule 14e-3 imposes liability on any person who trades while in "possession" of material information that relates to a tender offer*, if such person "knows or has reason to know" that the information is non-public. Rule 14e-3 therefore establishes liability regardless of whether or not there is an access-providing, special relationship with the issuer whose securities are being traded, and regardless of whether or not there is any duty to disclose.

Further, Rule 14e-3 imposes liability based upon a negligence standard rather than

*Rule 14e-3 is so broad that is will apply to any person who has information regarding a proposed tender offer, since the source of such information must, by definition, be (1) the offering person, (2) the issuer or (3) a person acting on behalf of the offeror or issuer.

upon a requirement of scienter, contrary to the decisions of this Court. See, Ernst & Ernst v. Hochfelder, 425 U.S. 185, (1976).

Sections 10(b) and 14(e) of the Exchange Act employ similar terms to prohibit certain securities transactions. The sections are governed by the same judicial standards and while Rule 14e-3 is clearly broader in scope than Rule 10b-5, their enabling sections, Section 14(e) and Section 10(b) are substantially identical. Since the Rule cannot be broader than the statute from which it is derived, (Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977)), Rule 14e-3 is impermissably overbroad and beyond the scope of Section 14(e).

An examination of the legislative history of Section 14(e) leads one to the same conclusion. Congress enacted the Williams

Act to prevent fraudulent tender offers by imposing disclosure requirements upon bidders. See, Senate Comm. on Banking and Currency, Full Disclosure of Corporate Equity Ownership and in Corporate Takeover Bids, S. Rep. No. 550, 90th Cong., 2nd Sess. (1967). While the congressional reports emphasize the need for a bidder to disclose material information to shareholders, the reports do not mention a duty to disclose which is applicable to any person other than those making or opposing the tender offer. See, House Comm. on Interstate and Foreign Commerce, H.R. Rep. No. 1711, 90th Cong. 2nd Sess. (1968)

While the various parties who testified at the Senate and House hearings expressed their desire to provide shareholders with the information necessary to make an informed decision regarding a tender offer (See, Bills

Providing for Full Disclosure of Corporate Equity Ownership Under the Securities Exchange Act of 1934: Hearings on H.R. 14475 and S.510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency, 90th Cong. 1st Sess. (1967), there is no evidence that Congress intended Section 14(e) to broaden the duty to disclose under the Exchange Act beyond the duty imposed under Section 10(b). Further, there is no indication that Congress intended to impose a duty upon one who is not in a fiduciary relationship to the parties to the tender offer.

Further, while the Senate and House reports concerning amendments to Section 14(e) reveal Congressional intent to grant the Commision rulemaking power to regulate schemes and devises used by bidders and

targets*, the reports do not indicate Congressional intent to regulate trading by non-bidders, where trading is based upon material non-public information. See, 1970 Senate Hearings.

Rule 14e-3 imposes liability upon anyone who trades on non-public information without first disclosing same. Not only is this Rule contrary to the Congressional intent behind the adoption of Section 14(e), this Rule, and its effect, are in direct conflict with Chiarella and Dirks.

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* See, An Act to Amend Sections 13(d) 13(e), 14(d) and 14(e), of the Securities Exchange Act of 1934 In Order To Provide Additional Consumer Protection for Investors: Hearings on S-3431 Before the Subcomm. on Commerce and Finance of the House Comm on Interstate and Foreign Commerce, 91st Cong. 2nd Sess. (1970); A Bill to Extend the Coverage of Sections 13(d),14(d) and 14(e) of the Securities Exchange Act of 1934 in Order to Provide Additional Protection for Investors: Hearings on S. 3431 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency, 91st Cong. 2nd Sess. (1970)(hereinafter referred to as the "1970 Senate Hearings").

Rule 14e-3 creates an impermissible duty to disclose that is beyond the intent of Congress, and beyond the scope of the Rule's parent statute. The Rule is in direct conflict to the decisions of this Court, and cannot form the basis for liability in the instant matter.

IV. THE COURT BELOW HAS IMPROPERLY CREATED DIFFERING STANDARDS OF LIABILITY UNDER RULE 10b-5, VARYING ONLY WITH THE IDENTITY OF THE PLAINTIFF

The decision below constitutes a radical departure from an axiom of our judical process, that in the absence of a conflict between the reasonably plain meaning of a statute and its legislative history, the words of the statute must prevail, and the language of the statute cannot be interpreted differently in different cases, absent some evidence of congressional intent for such a dicotomy.

See Aaron v. SEC, 446 U.S. 680 (1980).

This Court has always held that the standards and theories of civil liability under Rule 10b-5 are the same, irrespective of who the plaintiff might be. While the remedies available may differ because of an explicit Congressional statement of such differing remedies, the theory of liability, and the elements of a violation, must remain constant, whether the action is instituted by the government or a civil plaintiff. Aaron v. SEC, supra.

However, the Second Circuit has now created a dicotomy in Rule 10b-5 liability, by a series of cases, culuminating with the instant decision.

In U.S. v. Newman, supra, the Court held that a violation of Rule 10b-5 existed if a defendant misappropriated information from his employer and traded on the basis of

said information. However, in Moss v. Morgan Stanley, Inc., 719 F.2d 5, (1983) the Second Circuit held that the same defendants were not liable under the same misappropriation theory, to the sellers of the securities at issue. However, in the instant case, the Second Circuit has held that in an enforcement action, the misappropriation theory is a valid basis for establishing liability under Rule 10b-5.

The Second Circuit's irreconcilable opinions underscore the need for this Court's guidance in this area, for the decisions of the Second Circuit now remove the certainty which is the cornerstone of our system of jurisprudence, and makes Rule 10b-5 liability a function of the identity of the plaintiff, rather than a function of the conduct complained of.

CONCLUSION

This Court should grant the instant petition because of the importance of the expansive and varying application of the misappropriation theory and Rule 14e-3 by the Comission and the lower Federal courts. For these reasons it is respectfully submitted for a writ of certiorari should be granted.

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MJAD#50/a1

APPENDIX

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 66 August Term, 1984

(Argued August 29, 1984 Decided October 1, 1984)

Docket No. 84-6043

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff-Appellee,

—against—

ANTHONY MATERIA,
Defendant-Appellant.

Before:

KAUFMAN, MESKILL and PIERCE, *Circuit Judges.*

Materia appeals from a judgment of the United States District Court for the Southern District of New York (Brieant, *J.*) enjoining him from violating Sections 10(b) and 14(e) of the Securities Exchange Act of 1934, and Rules 10b-5 and 14e-3, and requiring him to disgorge $99,862.50 in unlawfully obtained profits.

Affirmed.

MARTIN H. KAPLAN, Gusrae, Kaplan & Bruno, New York, N.Y. (Mark J. Astarita on the brief), *for Defendant-Appellant.*

DANIEL L. GOELZER, Jacob H. Stillman, Rosalind C. Cohen, Robert Mills, Elizabeth E. Ashcraft, Securities and Exchange Commission, Washington, D.C., (Paul Gonson, of counsel) *for Plaintiff-Appellee.*

KAUFMAN, *Circuit Judge:*

Our era aptly has been styled, and well may be remembered as, the "age of information." Francis Bacon recognized nearly 400 years ago that "knowledge is power," but only in the last generation has it risen to the equivalent of the coin of the realm. Nowhere is this commodity more valuable or volatile than in the world of high finance, where facts worth fortunes while secret may be rendered worthless once revealed.

At a certain point, amorphous data must be translated into the written word. In the financial field, this transmogrification requires masses of information—much of it highly sensitive—to be channeled through the financial printing firms that service our great commercial centers. It was in one such firm that Anthony Materia worked. Materia stole information to which he was privy in his work, and traded on that information to his pecuniary advantage. The Securities and Exchange Commission ("SEC" or "Commission") sought—and the district court granted—an injunction against Materia, restraining him from such activities in the future and requiring him to disgorge his ill-gotten gains. In light of the broad prophylactic coverage of the antifraud provisions of the securities laws, particularly where they are sought to be enforced by the SEC, we affirm the decision below, and hold that Materia's misappropriation of mate-

rial nonpublic information, and his subsequent trading on that information, violate Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. Recognizing the complexity attendant to an examination of Section 10(b) and Rule 10b-5, we find it necessary to set forth the facts in this dispute.

I.

Anthony Materia was employed by Bowne of New York City, Inc. (Bowne), a firm specializing in the printing of financial documents, including many used by its corporate clients in connection with proposed tender offers. Because even a hint of an upcoming tender offer may send the price of the target company's stock soaring, information regarding the identity of a target is extremely sensitive and zealously guarded. It is customary, therefore, for offerors (or their law firms, which ordinarily draft such documents) to omit information that might tend to identify a target company until the last possible moment. Code names are used, blanks are left to be filled in on the eve of publication, and occasionally misinformation is even included in early drafts. In sum, a quick reading of preliminary versions of these sensitive papers would not reveal the information sought to be guarded.

Anthony Materia did not read such material quickly. In his job as a "copyholder," Materia read clients' drafts aloud to a proofreader, who in turn checked to make certain that page proofs conformed to the copy received from the client. If copyholding was Materia's vocation, the stock market appears to have been equally consuming. Notwithstanding scrupulous efforts by Bowne and its

clients to keep confidential information confidential,[1] Materia was able to divine the identities of at least four tender offer targets in the period between December 1980 and September 1982.[2] Within hours of each discovery, he purchased stock, and within days—after the offer had been made public—he sold his holdings at substantial gains.

Soon after Materia completed his purchase and sale of securities in the fourth target company, the Securities and Exchange Commission filed an enforcement action, charging that he had violated and was about to violate Sections 10(b) and 14(e) of the Securities Exchange Act of 1934, 48 Stats. 881, as amended, 15 U.S.C. §§ 78j(b), 78n(e) (1982), and Rules 10b-5 and 14e-3, 17 C.F.R. §§ 240.10b-5, 240.14e-3 (1983). The basis of its complaint was Materia's trading in securities on the basis of material nonpublic information he had misappropriated from his employer and its clients.[3]

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[1] Not wishing to rely solely on the difficulties inherent in deciphering codes and filling in blanks, Bowne had a policy explicitly forbidding its employees from trading on information they might come across in the course of their work. Written statements of this prohibition were posted conspicuously in Bowne's plant, and copies were distributed to all employees.

[2] Although the names of the target companies were deleted from the preliminary drafts to which Materia had access, sufficient data were included to permit an avid market watcher such as Materia to deduce their identities. For example, in the case of one offering document, the target's state of incorporation, number of outstanding shares and dates and amounts of recent dividends were included in early versions.

[3] In its first amended complaint, the Commission also alleged that Materia conveyed information regarding at least three of the tender offer targets to his wife, who in turn purchased securities in those companies. The district court found there had been no showing that Mrs. Materia knew or should have known that the information conveyed to her was confidential, and denied the Commission's request for relief against her.

Following a fourteen-day nonjury trial, Judge Brieant delivered an opinion and order from the bench. He found that Materia had, in fact, traded on the basis of confidential data stolen from Bowne and the offerors. Moreover, he explicitly found that Materia had breached a fiduciary duty to his employer and its clients to maintain their confidences. Finally, he concluded that Materia had actual knowledge of this duty, and thus had acted with scienter. Accordingly, Judge Brieant held that Materia had violated Sections 10(b) and 14(e), and Rules 10b-5 and 14e-3. The court issued a permanent injunction, restraining him from continuing violations. In addition, Materia was ordered to disgorge his illegally obtained profits of $99,862.50. Final judgment was entered on Judge Brieant's order, and Materia timely filed this appeal.

II.

At the outset, the nature and procedural posture of this action bear description, for they delineate the parameters of our inquiry. This suit was brought, not by an investor injured as a result of Materia's connivances, but by the Securities and Exchange Commission—the governmental body charged by law with the protection of our financial markets.

The sweeping mandate manifest in the securities laws would be all but meaningless were it not for the broad investigatory and enforcement powers created under the statutory scheme. Our inquiry today is directed to Section 21(d) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78u(d) (1982), which empowers the Commission to seek a "temporary or permanent injunc-

tion" against "any person [who] is engaged or is about to engage in acts or practices constituting a violation" of the securities laws. A trial judge is vested with considerable discretion in granting injunctive relief pursuant to this section. There need be only a reasonable likelihood that the activity complained of will be repeated. *See SEC* v. *Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1102 (2d Cir. 1972). Moreover, once the equity jurisdiction of the district court properly has been invoked, the court has power to order all equitable relief necessary under the circumstances. *See Chris-Craft Industries, Inc.* v. *Piper Aircraft Corp.*, 480 F.2d 341, 390 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973). Such discretion in fashioning appropriate remedies is a necessary (if unspoken) concomitant of the legislative grant of power to enforce the laws. The Supreme Court has written:

> When Congress entrusts to an equity court the enforcement of prohibitions contained in a regulatory enactment, it must be taken to have acted cognizant of the historic power of equity to provide complete relief in light of the statutory purposes.

Mitchell v. *Robert DeMario Jewelry, Inc.*, 361 U.S. 288, 291-92 (1960).

Mindful of this principle, we cannot read Section 21(d) as restricting the remedies the SEC may pursue solely to injunctive relief. *See SEC* v. *Texas Gulf Sulphur Co.*, 446 F.2d 1301, 1307-08, *cert. denied*, 404 U.S. 1005 (1971). On the contrary, any form of ancillary relief may be granted where necessary and proper to effectuate the purposes of the statutory scheme. *Id.* at 1308; *see J. I. Case Co.* v. *Borak*, 377 U.S. 426, 433-34 (1964). Given the federal courts' broad equitable powers,

such noninjunctive relief may take a variety of forms. *See* Farrand, Ancillary Remedies in SEC Civil Enforcement Actions, 89 Harv. L. Rev. 1779 (1976). In the past, the Commission has sought and obtained the appointment of a receiver for a corporation the affairs of which were in disarray as the result of past violations, *see Manor Nursing Centers, supra,* impoundment of assets, *see International Controls Corp.* v. *Vesco,* 490 F.2d 1334 (2d Cir.), *cert. denied,* 417 U.S. 932 (1974), and the installation of Commission approved directors on the board of a defendant corporation, *see id.* Disgorgement of illegally obtained profits is by no means a new addition to this catalogue of permissible equitable remedies. Indeed, in *Texas Gulf Sulphur, supra,* this court affirmed a district court order requiring individual defendants to pay over the profits realized from trading on insider information. And in *Manor Nursing Centers, supra,* we upheld an order requiring disgorgement of proceeds from a stock offering found to have violated the securities laws.

Accordingly, the forms of relief granted by Judge Brieant—a permanent injunction against future violations, and the disgorgement of profits resulting from Materia's past activities—were appropriate once it was determined that Materia's actions were proscribed by law. It is to that ultimate question we now turn.

III.

Materia does not contest the district court's finding that he misappropriated confidential information and traded on it to his advantage. His sole argument is that such activity does not contravene Section 10(b) and Rule 10b-5. In light of this court's holding in *United States*

v. *Newman*, 664 F.2d 12 (2d Cir. 1981), *aff'd after remand*, No. 82-1273 (2d Cir., Feb. 8, 1983) (unpublished order), *cert. denied*, 104 S. Ct. 193 (1983), we hold that such actions do, indeed, lie within the proscriptive purview of the antifraud provisions of the securities laws.

Newman addressed the criminal liability under Section 10(b) and Rule 10b-5 of an individual defendant charged with participating in a scheme to misappropriate confidential information regarding upcoming tender offers. Along with his co-conspirators, employees of two investment banking firms, Newman surreptitiously gathered and traded on this nonpublic data. The court held that Newman's "conduct . . . could be found to constitute a criminal violation of Section 10(b) and Rule 10b-5 . . . ." *Newman, supra*, at 16. The facts in the instant appeal are sufficiently similar to those in *Newman* for us to affirm on the authority of that precedent alone. To delineate the contours of what may still be perceived as a novel theory of liability under the antifraud provisions, we choose, however, to elucidate the bases for our holding.

a.

Rule 10b-5, promulgated in 1942 pursuant to the Commission's rulemaking power under Section 10(b), makes it "unlawful for any person . . . [t]o engage in any act . . . which operates . . . as a fraud or deceit upon any person, in connection with the purchase or sale of securities." 17 C.F.R. § 240.10b-5 (1984). As in *Newman*, "we need spend little time on the issue of fraud and deceit." *Newman, supra*, at 17. Materia "misappropriated—stole to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence."

United States v. *Chiarella*, 445 U.S. 222, 245 (1980) (Burger, C.J., dissenting). We hold that such activity falls squarely within the "fraud or deceit" language of the Rule. Legislative history to the Securities Exchange Act of 1934 makes clear that the antifraud provision was intended to be broad in scope, encompassing all "manipulative and deceptive practices which have been demonstrated to fulfill no useful function." S. Rep. No. 792, 73d Cong., 2d Sess., 6 (1934). This language negates the suggestion that the provision was aimed solely at the eradication of fraudulent trading by corporate insiders. Against this expansive construction of "fraud or deceit," Materia's theft of information was indeed as fraudulent as if he had converted corporate funds for his personal benefit. *See Newman, supra*, at 17; *cf. Texas Gulf Sulphur, supra*, at 1308; *Diamond* v. *Oreamuno*, 24 N.Y.2d 494, 499, 301 N.Y.S.2d 78, 248 N.E.2d 910 (1969).

In an effort to circumvent this conclusion, Materia attempts to argue that he could not have defrauded his employer, since he was unaware of the confidential nature of the information he handled in the course of his work. Judge Brieant explicitly found that Bowne's diligent efforts to communicate the need for secrecy vitiated this claim, and the record contains ample support for such a finding. We find similarly unavailing Materia's argument that Bowne was not injured as a result of his misappropriation of client information. Among a financial printer's most valuable assets is its reputation as a safe repository for client secrets. By purloining and trading on confidences entrusted to Bowne, it cannot be gainsaid that Materia undermined his employer's integrity. *See Newman, supra*, at 17. Accordingly, we are driven to the conclusion that, by his misappropriation of material

nonpublic information, Materia perpetrated a fraud upon Bowne.[4]

Such a determination, however, merely begins a tripartite inquiry. We turn next to Materia's contention that the only fraud properly giving rise to an action under 10(b) and 10b-5 is one premised upon a duty to disclose.

b.

With the barrage of private civil actions, it is "easy to forget that Section 10(b) was written as both a regulatory and criminal piece of legislation." *Newman, supra*, at 16; *see* 15 U.S.C. §§ 78u, 78ff (1982). The private right of action under that section is a judicial, rather than a legislative creation. Nowhere in the Securities Exchange Act of 1934 can be found an express private civil remedy for the violation of its terms. Indeed, a perusal of the legislative history surrounding the promulgation of Section 10(b) fails to reveal any indication that Congress contemplated a private right of action. *See,* S. Rep. No. 792, 73d Cong., 2d Sess., 5-6 (1934); Note, Implied Liability Under the Securities Exchange Act, 61 Harv. L. Rev. 858, 861 (1948). Moreover, in adopting Rule 10b-5 in 1942, the Commission did not address, and in fact did not consider, the question of private civil remedies under the provision. *See* SEC Securties Exchange Act Release No. 3230 (1942). Only

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[4] It is axiomatic that
an agent is subject to a duty to the principal not to use or communicate information confidentially given to him by the principal or acquired by him during the course of or on account of his agency . . . .
Restatement (Second) of Agency § 359 (1958).

by fashioning the private right with which we are by now so familiar, were courts forced to deal with ancillary issues such as standing, *see Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 823 (1975), and whether a defendant has breached a duty to a particular plaintiff, *see Moss* v. *Morgan Stanley, Inc.*, *supra*. Indeed, these issues are germane only in the context of private civil litigation. In reviewing an enforcement action such as this, our concern "must be with the scope of the Rule," *Newman*, *supra*, at 17, rather than the precise direction in which a duty may have been owed. For this reason, Materia's attempted reliance on *Chiarella* v. *United States*, 445 U.S. 222 (1980), is misplaced.

Chiarella, like Materia, was an employee of a financial printing firm. He, too, divined the identities of tender offer targets from confidential documents and traded on that information for his personal gain. Affirming his criminal conviction under Section 10(b), this court held that Chiarella had breached an affirmative duty to disclose material nonpublic information to those from whom he purchased securities. *See United States* v. *Chiarella*, 588 F.2d 1358, 1364-69 (2d Cir. 1978). Additionally, we ruled that liability could be premised upon his having misappropriated the information from his employer and its clients. *Id.* at 1368 n.14. Although the Supreme Court explicitly reversed on the first theory, holding that the mere possession of confidential information is insufficient to create a duty to disclose that information to those on the other side of the market, *see Chiarella* v. *United States*, 445 U.S. 222 (1980), it did not similarly disavow the misappropriation theory. Rather, a majority held that the theory could not support Chiarella's conviction because it had not been submitted to the jury. *See id.* at 235-37. Accordingly, "resolution

of this issue [was left] for another day." *Id.* at 238 (Stevens, J., concurring).

As Judge Pierce made clear at oral argument, in this circuit that day arrived in October 1981, with the filing of the *Newman* decision. We announced then, and reiterate now, that one who misappropriates nonpublic information in breach of a fiduciary duty and trades on that information to his own advantage violates Section 10(b) and Rule 10b-5.[5]

Moss v. *Morgan Stanley Co., supra,* relied on by Materia, does not suggest otherwise. That case, arising out of the same facts as *Newman,* was a private action brought by shareholders who unwittingly sold stock to Newman and his cohorts. This court affirmed the dismissal of the action on the same limited grounds announced by the Supreme Court in *Chiarella.* The defendants owed no duty to the plaintiffs. At the risk of repetition, we stress that such analysis bears only on the type of question raised in a private suit for damages; it is not relevant to an inquiry into whether the Rule was or was not contravened.

c.

Having decided that Materia's actions were fraudulent within the meaning of the securities laws, and having found that the misappropriation of his employer's property satisfies the "upon any person" language of 10b-5,

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[5] Materia argues that, if his activities are not found to violate Section 10(b) or Rule 10b-5, they cannot give rise to an action under Rule 14e-3. We need not address his theories regarding a limited grant of rulemaking powers, however, for we have already held that his actions contravene 10(b) and 10b-5.

we are left with Materia's spurious argument that his fraud was not "in connection with" the purchase or sale of securities. Indeed, such a suggestion is inimical to the letter and spirit of the expansive scheme created to combat fraud in the securities markets. The information Materia stole has no value whatsoever except "in connection with" his subsequent purchase of securities. The fraud perpetrated on his employer was part and parcel of a larger design, the sole purpose of which was to reap instant no-risk profits in the stock market. Whatever limitations have been read into the "in connection with" language in the past, *see generally Blue Chip Stamps* v. *Manor Drug Stores, supra,* at 731-33 (in private civil action under Section 10(b), "in connection with" language limits standing to a purchaser or seller of securities), it is clear that the requirement is satisfied by the self-evident nexus presented in this case.

IV.

For all intents and purposes, the question of Anthony Materia's liability was settled fifty years ago. Determined to combat fraud in the securities marketplace, Congress chose to enact a comprehensive yet open-ended statutory scheme, capable of ongoing adaptation and refinement. In recent years, developments in capital formation and novel means of effecting corporate combinations have spawned a new genre of confidential information. Courts are increasingly called upon to address a myriad of issues regarding the proprietorship and exploitation of such data. Nevertheless, the lodestar of our analysis must be the meaning gleaned from a thorough inquiry into legislative purpose. We do not believe the drafters of the Securities Exchange Act of 1934—envisaging as they did an open and honest market—would have

countenanced the activities engaged in by Anthony Materia.

Accordingly, the decision of the district court is affirmed.

UNITED STATES COURT OF APPEALS
for the
SECOND CIRCUIT

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the first day of October, one thousand nine hundred and eighty four.

Present:

Hon. Irving R. Kaufman

Hon. Thomas J. Meskill

Hon. Lawrence W. Pierce

CIRCUIT JUDGES

SECURITIES and EXCHANGE COMMISSION,

Plaintiff-Appellee,

84-6043

against

ANTHONY MATERIA,

Defendant-Appellant.

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is affirmed in accordance with the opinion of this Court with costs to be taxed against the appellant.

Elaine B. Goldsmith,
Clerk

By: s/Edward J. Guardino
Edward J. Guardino,
Deputy Clerk

Filed, United States Court of Appeals, Second Circuit, October 1, 1984.

THE MANDATE, CONSISTING OF THE ITEMS BELOW, HAS BEEN RECEIVED.

___ OPINION ____ ORDER

____ STATEMENT OF COSTS.
RECEIVED BY /s/ Date: 11/5/84

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